production acceptance testing. The proposed restricted area would provide improved capabilities for the ammunition acceptance testing program and mine testing facility activities. The proposed restricted area would be joint use. When not being utilized by Yuma Proving Ground, it would be released to the controlling agency, Yuma Approach Control. The coordinates for this airspace docket are based on North American Datum 83. Section 73.23 of part 73 of the Federal Aviation Regulations was republished in FAA Order 7400.8B dated March 9, 1994.

The FAA has determined that this proposed regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. It, therefore—(1) is not a ''significant regulatory action'' under Executive Order 12866; (2) is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this rule, when promulgated, will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

## Environmental Review

An environmental impact statement (EIS) concerning the proposal has been prepared by the U.S. Army. The FAA will review the EIS prior to an FAA final decision on the proposal. The results of the review will be addressed in any subsequent rulemaking action.

## List of Subjects in 14 CFR Part 73

Airspace, Navigation (air).

## The Proposed Amendment

In consideration of the foregoing, the Federal Aviation Administration proposes to amend 14 CFR part 73 as follows:

## PART 73—[AMENDED]

1. The authority citation for part 73 continues to read as follows:

**Authority:** 49 U.S.C. app. 1348(a), 1354(a), 1510, 1522; E.O. 10854, 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389; 49 U.S.C. 106(g); 14 CFR 11.69.

2. Section 73.23 is amended as follows:

### § 73.23 [Amended]

**R–2311 Yuma Proving Ground, Yuma, AZ [New]**

Boundaries. Beginning at lat. 32°46′48″ N., long. 114°19′16″ W.; to lat. 32°51′20″ N., long. 114°19′04″ W.; to lat. 32°51′53″ N., long. 114°03′40″ W.; to lat. 32°46′48″ N., long. 114°03′51″ W.;
to the point of beginning.

Altitudes. Surface to 3,500 feet MSL.

Time of designation. Sunrise to sunset, Monday–Saturday; other times by NOTAM.

Controlling Agency. Yuma Approach Control.

Using Agency. U.S. Army, Commanding Officer, Yuma Proving Ground, Yuma, AZ.

Issued in Washington, DC, on December 21, 1994.

**Harold W. Becker,**

*Manager, Airspace-Rules and Aeronautical Information Division.*

[FR Doc. 95–367 Filed 1–5–95, 8:45am]

BILLING CODE 4910–13–P

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## DEPARTMENT OF THE TREASURY

## Internal Revenue Service

## 26 CFR Part 1

**[INTL–933–86]**

**RIN 1545–AL98**

# Computation of Foreign Taxes Deemed Paid Under Section 902 Pursuant to a Pooling Mechanism for Undistributed Earnings and Foreign Taxes

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed income tax regulations relating to the computation of foreign taxes deemed paid under section 902. Changes to the applicable law were made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). These regulations would provide guidance needed to comply with these changes and affect foreign corporations and their United States corporate shareholders.

**DATES:** Comments and requests for a public hearing must be received by April 6, 1995.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:T:R (INTL–933–86), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. In the alternative, submissions may be hand delivered to: CC:DOM:CORP:T:R (INTL–933–86), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Caren S. Shein (202) 622–3850, or Kristine K. Schlaman (202) 622–3840.

**SUPPLEMENTARY INFORMATION:**

## Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer PC:FP, Washington, DC 20224.

The collection of information requirement in this regulation is in § 1.902–1(e). This information is required by the IRS to implement section 902 as amended by the Tax Reform Act of 1986. This information will be used by law enforcement authorities with respect to the enforcement of Federal laws. The likely respondents are businesses or other for-profit institutions.

Estimated total annual reporting burden: 225,520 hours.
Estimated total annual burden per respondent: 112.76 hours.
Estimated number of respondents: 2000.
Estimated annual frequency of response: one.

## Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 902 of the Internal Revenue Code of 1986. These amendments are proposed to conform the regulations to section 1202(a) of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 1085), and to section 1012(b) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (Pub. L. 100–647, 102 Stat. 3242).

## Proposed Effective Dates

These regulations are proposed to be effective for taxable years beginning after December 31, 1986.

## Explanation of Provisions

*Section 1.902–1*

Section 902 provides a mechanism by which foreign income taxes paid by a foreign corporation are deemed paid by a domestic corporate shareholder owning at least 10 percent of the voting stock of the foreign corporation. Paragraphs (a) (1) through (12) of

§ 1.902–1 provide definitions applicable for purposes of section 902 and §§ 1.902–1 and 1.902–2.

Paragraph (a)(1) defines a domestic shareholder that is eligible for the section 902 credit as a domestic corporation that owns directly at least 10 percent of the voting stock of a foreign corporation at the time it receives a dividend.

Revenue Ruling 71–141, 1971–1 C.B. 211, allows two 50 percent domestic corporate general partners of a domestic general partnership to claim a credit for taxes deemed paid under section 902 for foreign taxes paid by a foreign corporation in which the partnership owned 40 percent of the voting stock. The Internal Revenue Service is considering under what other circumstances a section 902 credit with respect to stock held by a partnership or other pass-through entity should flow through to a domestic corporation. The Service requests comments on whether the holding of Rev. Rul. 71–141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, and beneficiaries of domestic or foreign trusts and estates or interest holders in other pass-through entities. The comments should address how the Service would administer any proposed expansion of the revenue ruling to allow deemed paid credits through other pass-through entities.

Paragraphs (a) (2) through (6) define the ownership requirements that must be met before foreign income taxes of a first-, second-, or third-tier foreign corporation will be deemed paid by an upper-tier foreign corporation or a domestic shareholder.

Paragraph (a)(7) defines foreign income taxes as those creditable under sections 901 and 903. Paragraph (a)(8) defines post-1986 foreign income taxes generally as foreign income taxes paid, accrued, or deemed paid for the current year and any foreign income taxes paid, accrued, or deemed paid in prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid on earnings previously distributed to or otherwise included in the income of a shareholder.

Paragraph (a)(9) defines post-1986 undistributed earnings generally as the amount of earnings and profits accumulated by a foreign corporation in taxable years beginning after December 31, 1986, determined as of the close of the taxable year in which a dividend is distributed. Post-1986 undistributed earnings are not reduced by dividend distributions and deemed inclusions in the current year but are reduced by dividend distributions and deemed inclusions in prior post-1986 taxable years.

Paragraph (a)(10) defines pre-1987 accumulated profits as earnings and profits accumulated in taxable years beginning before January 1, 1987, and in later years if the special effective date of paragraph (a)(13) applies. Paragraph (a)(13) provides a special effective date applicable when the 10-percent ownership requirements of section 902(c)(3)(B) and paragraphs (a) (1) through (4) are first met with respect to a foreign corporation in a taxable year of the foreign corporation beginning after December 31, 1986. For post-1986 years prior to the first year in which the ownership requirements of section 902(c)(3)(B) are met, foreign taxes deemed paid must be computed under the rules of section 902 as in effect prior to the Tax Reform Act of 1986. See section 902(c)(6).

The proposed regulations specify that both post-1986 undistributed earnings and pre-1987 accumulated profits include a foreign corporation's entire earnings and profits. Further, for both post-1986 undistributed earnings and pre-1987 accumulated profits that are distributed in a taxable year beginning after December 31, 1986, the proposed regulations state that special allocations of accumulated profits and taxes to particular shareholders, whether required or permitted under foreign law or an agreement among the shareholders, will be disregarded. See paragraphs (a)(9)(iv) and (a)(10)(ii).

The intent of the proposed regulations is to reverse the Tax Court's decision in *Vulcan v. Commissioner,* 96 T.C. 410 (1991), affd. per curiam 959 F.2d 973 (11th Cir. 1992), for distributions in taxable years beginning after December 31, 1986, out of pre-1987 accumulated profits. In addition, the regulations are intended to make clear that the decision in *Vulcan* is not applicable to distributions out of post-1986 undistributed earnings.

In *Vulcan,* the Tax Court held that the term ''accumulated profits'' as used in the denominator of the section 902 deemed paid credit fraction prior to the Tax Reform Act of 1986 does not necessarily mean all of a foreign corporation's accumulated profits. The Tax Court concluded that the pre-1987 statute and regulations under section 902 were unclear and based its decision on what it viewed as the policy behind section 902. The pre-Tax Reform Act of 1986 version of section 902 described the creditable foreign tax as that levied ''on or with respect to the accumulated profits of the foreign corporation from which such dividends were paid.'' The Tax Court in *Vulcan* read this language as linking ''accumulated profits'' to the foreign tax paid by the subsidiary and, based in part on this reading, computed the section 902 credit using only the amount of accumulated profits on which the foreign tax was levied.

Contrary to the Tax Court's analysis, the term ''accumulated profits'' as used in pre-1987 section 902 generally is equated with, and determined in accordance with, United States tax principles relating to pre-tax earnings and profits. *See United States* v. *Goodyear Tire and Rubber Company,* 493 U.S. 132, 139 (1989). Earnings and profits are a measure of a corporation's ability to pay dividends. They generally are determined at the corporate level and include all income earned by the corporation, whether or not all or any portion of the income is subject to tax. The ''on or with respect to'' language on which the Tax Court focused simply reflects the annual nature of the section 902 credit calculation prior to 1986, and does not permit or require the computation of the deemed paid credit using less than all of the foreign corporation's accumulated profits.

The 1986 Act changes to section 902(a) eliminated the language the Tax Court relied on in *Vulcan* to link the taxes to be credited to the particular profits on which they were paid. See H.R. Rep. (Conf.) 841, 99th Cong., 2d Sess. II–589 (1986). As amended in 1986, section 902 simply defines the pool of creditable taxes as ''any income, war profits, or excess profits taxes paid by the foreign corporation'' to the foreign taxing authority. See section 902(c)(4). The proposed regulations make clear that *Vulcan* does not apply for years to which the pooling rules of new section 902 apply.

The proposed regulations would reverse *Vulcan* for distributions out of pre-1987 accumulated profits in post-1986 taxable years. The *Vulcan* reversal for distributions out of pre-1987 accumulated profits thus will have a continuing impact in post-1986 years. The Internal Revenue Service published this position in Rev. Rul. 87–14, 1987–1 C.B. 181. Thus, taxpayers had notice of the rule prior to the issuance of these proposed regulations.

Paragraph (a)(10)(iii) provides that foreign income taxes of a particular year with pre-1987 accumulated profits must be reduced by the amount of foreign income taxes deemed paid on a distribution or inclusion out of pre-1987 accumulated profits of that year. Foreign income taxes paid or accrued on or with respect to pre-1987 accumulated profits must be translated into United States dollars under the rules in effect prior to the effective date of the Tax Reform Act of 1986. See *The Bon Ami Company v. Commissioner,* 39 B.T.A. 825 (1939).

Paragraph (b)(1) provides rules for computing the foreign income taxes deemed paid by a domestic shareholder, first-tier corporation or second-tier corporation for any taxable year in which a domestic shareholder receives a dividend from a first-tier corporation paid out of post-1986 undistributed earnings, or an upper-tier corporation receives a dividend from a lower-tier corporation paid out of post-1986 undistributed earnings.

Paragraph (b)(2) provides rules for allocating dividends to post-1986 undistributed earnings and pre-1987 accumulated profits when a foreign corporation pays a dividend out of both post-1986 undistributed earnings and pre-1987 accumulated profits and out of more than one pre-1987 taxable year. Paragraph (b)(3) provides that the amount of foreign taxes deemed paid on a dividend out of pre-1987 accumulated profits must be computed under section 902 as in effect prior to the effective date of the Tax Reform Act of 1986.

Paragraph (b)(4) provides that if a foreign corporation makes a distribution out of current earnings and profits that is treated as a dividend under section 316(a)(2) in a taxable year in which the corporation has a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero, then no foreign income taxes shall be deemed paid with respect to the dividend. See S. Rep. No. 313, 99th Cong., 2d Sess. 321 (1986). The dividend reduces post-1986 undistributed earnings and accumulated earnings and profits.

Paragraph (c) provides special rules applicable in computing foreign taxes deemed paid by a domestic shareholder or upper-tier corporation. Paragraph (c)(1) provides that foreign taxes deemed paid must be computed separately for dividends received from each foreign corporation. Further, if a domestic shareholder receives a dividend from a first-tier corporation and in the same taxable year the first-tier corporation receives a dividend from one or more lower-tier corporations, then foreign taxes deemed paid are computed by starting at the lowest tier and working upward.

Paragraph (c)(2) requires a domestic shareholder to include in gross income as a dividend under section 78 all foreign taxes deemed paid for the taxable year. Foreign corporations are not required to include foreign taxes deemed paid in gross income under section 78.

Paragraph (c)(9) incorporates the rules of section 905(c) to determine the effect of a section 482 adjustment on post-1986 undistributed earnings and post-1986 foreign income taxes. In general, section 905(c) and the regulations under that section require a reduction in the pool of creditable foreign income taxes when a taxpayer fails to exhaust its administrative remedies to obtain a refund of foreign income taxes paid following a section 482 adjustment. See also Rev. Rul. 92–74, 1992–2 C.B. 156.

Paragraph (d) provides rules relating to the computation of foreign taxes deemed paid with respect to dividends from controlled foreign corporations. Generally, dividend distributions are treated as made pro rata out of a controlled foreign corporation's earnings in each section 904(d) separate category. Section 1.904–5(d). Paragraph (d)(3)(i) provides that dividends distributed out of earnings accumulated before a foreign corporation became a controlled foreign corporation are treated as dividends from a noncontrolled section 902 corporation, whether the earnings are post-1986 undistributed earnings or pre-1987 accumulated profits.

Pursuant to a grant of regulatory authority in section 904(d)(2)(E)(i), and consistent with proposed amendments to § 1.904–4(g)(3), paragraph (d)(3)(ii) generally limits the application of the Technical and Miscellaneous Revenue Act of 1988 amendment of section 904(d)(2)(E)(i) (restricting look-through treatment on dividends out of pre-acquisition earnings of a controlled foreign corporation) to U.S. shareholders that acquire more than 90% voting stock ownership in an existing controlled foreign corporation (including both U.S. shareholders who previously owned no voting stock in the controlled foreign corporation and U.S. shareholders that previously owned less than 10% of the controlled foreign corporation's voting stock). A U.S. shareholder that acquires more than 90% ownership of a controlled foreign corporation's voting stock must begin a new set of post-1986 undistributed earnings and post-1986 foreign income taxes pools on the first day of the first taxable year in which it owns more than 90% of the voting stock. Earnings attributable to the pre-acquisition period are treated as post-1986 undistributed earnings or pre-1987 accumulated profits of a noncontrolled section 902 corporation. Distributions will be deemed to come first out of the post-acquisition earnings pools to the extent thereof, and then out of pre-acquisition earnings.

A U.S. shareholder that acquires stock resulting in ownership of 90% or less of an existing controlled foreign corporation's voting stock is entitled to look-through treatment on dividends paid out of pre-acquisition earnings of the controlled foreign corporation. The shareholder need not start new pools of earnings and taxes as a result of its acquisition of voting stock of the controlled foreign corporation.

Paragraph (e) describes the information a domestic shareholder must furnish with respect to foreign income taxes for which it claims a deemed paid credit.

Paragraph (f) provides examples illustrating the rules of § 1.902–1, and paragraph (g) provides that § 1.902–1 applies to distributions in and after a foreign corporation's first taxable year beginning on or after January 1, 1987.

*Section 1.902–2*

Section 1.902–2 provides rules for computing foreign taxes deemed paid when there are deficits in post-1986 undistributed earnings or pre-1987 accumulated profits (determined under section 902) of a foreign corporation. Paragraph (a)(1) provides that if there is a deficit in post-1986 undistributed earnings of a first-, second-, or third-tier corporation and the corporation makes a distribution to shareholders, then the deficit shall be carried back to the most recent pre-effective date taxable year of the first-, second-, or third-tier corporation with positive accumulated profits determined under section 902. The amount carried back will be removed from post-1986 undistributed earnings, but any foreign income taxes paid with respect to those earnings will not be carried back to a taxable year beginning before January 1, 1987 (or a later year if the special effective date of § 1.902–1(a)(13) applies) and will not be removed from post-1986 foreign income taxes.

Paragraph (b)(1) provides that if there is a deficit in accumulated profits determined under section 902 of a first-, second-, or third-tier corporation as of the end of its last pre-effective date taxable year, that deficit must be carried forward to the first taxable year of the foreign corporation beginning after December 31, 1986, or later if the special effective date of § 1.902–1(a)(13) applies. The deficit carried forward is included in and reduces post-1986 undistributed earnings. Foreign income taxes paid with respect to pre-effective date years are not carried forward.

Paragraph (b)(2) makes clear that if a corporation has a deficit in section 902 accumulated profits at the end of its last pre-effective date year, then absent an adjustment that restores earnings to a pre-effective date taxable year (for example, a refund of foreign taxes) the corporation will never be able to pay a dividend out of pre-effective date earnings and profits, and thus will not be able to claim a credit for taxes deemed paid under section 902 for any foreign income taxes remaining in pre-effective date years.

The regulations redesignate §§ 1.902–1 and 1.902–2 of the existing final regulations as §§ 1.902–3 and 1.902–4, respectively, and make conforming amendments to those regulations.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Request for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

**Drafting Information**

The principal author of these proposed regulations is Caren Silver Shein of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

## PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

**Authority:** 26 U.S.C. 7805 * * * Section 1.902–1 also issued under 26 U.S.C. 902(c)(7). Section 1.902–2 also issued under 26 U.S.C. 902(c)(7). * * *

### §§ 1.902–1 and 1.902–2 [Redesignated §§ 1.902–3 and 1.902–4]

**Par. 2.** Sections 1.902–1 and 1.902–2 are redesignated §§ 1.902–3 and 1.902–4, respectively.

**Par. 3.** Sections 1.902–0, 1.902–1 and 1.902–2 are added to read as follows:

### § 1.902–0 Outline of regulations provisions for section 902.

This section lists the provisions under section 902.

### § 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.

**§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid § 1.902–1.**

(a) Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years.
(1) Rule.
(2) Examples.
(b) Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902.
(1) General rule.
(2) Effect of pre-effective date deficit.
(3) Examples.

**§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.**

(a) Definitions.
(1) Domestic shareholder.
(2) First-tier corporation.
(3) Second-tier corporation.
(4) Third-tier corporation.
(5) Foreign income taxes.
(6) Dividend.
(7) Dividend received.
(b) Domestic shareholder owning stock in a first-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a domestic shareholder.
(c) First-tier corporation owning stock in a second-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a first-tier corporation.
(d) Second-tier corporation owning stock in a third-tier corporation.
(1) In general.
(2) Amount of foreign taxes deemed paid by a second-tier corporation.
(e) Determination of accumulated profits of a foreign corporation.
(f) Taxes paid on or with respect to accumulated profits of a foreign corporation.
(g) Determination of earnings and profits of a foreign corporation.
(1) Taxable year to which section 963 does not apply.
(2) Taxable year to which section 963 applies.
(3) Time and manner of making choice.
(4) Determination by district director.
(h) Source of income from first-tier corporation and country to which tax is deemed paid.
(1) Source of income.
(2) Country to which taxes deemed paid.
(i) United Kingdom income taxes paid with respect to royalties.
(j) Information to be furnished.
(k) Illustrations.
(l) Effective date.

**§ 1.902–4 Rules for distributions attributable to accumulated profits for taxable years in which a first-tier corporation was a less developed country corporation.**

(a) In general.
(b) Combined distributions.
(c) Distributions of a first-tier corporation attributable to certain distributions from second- or third-tier corporations.
(d) Illustrations.

**§ 1.902–1 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid by the foreign corporation.**

(a) *Definitions and special effective date.* For purposes of section 902 and §§ 1.902–1 and 1.902–2, the definitions provided in paragraphs (a) (1) through (12) of this section and the special effective date of paragraph (a)(13) of this section apply.

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation from a foreign corporation after December 31, 1986, the term domestic shareholder means a domestic corporation, other than an S corporation as defined in section 1361(a), that owns directly at least 10 percent of the voting stock of the foreign corporation at the time the domestic corporation receives a dividend from that foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder from a foreign corporation in a taxable year beginning after December 31, 1986, the term first-tier corporation means a foreign corporation, at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time the domestic shareholder receives a dividend from that foreign corporation. The term first-tier corporation also means a DISC or former DISC, but only with respect to dividends from the DISC or former DISC that are treated under sections 861(a)(2)(D) and 862(a)(2) as income from sources without the United States.

(3) *Second-tier corporation.* In the case of dividends paid to a first-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, the foreign corporation is a second-tier corporation if, at the time a first-tier corporation receives a dividend from that foreign corporation, the first-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation.

(4) *Third-tier corporation.* In the case of dividends paid to a second-tier corporation by a foreign corporation in a taxable year beginning after December 31, 1986, a foreign corporation is a third-tier corporation if, at the time a second-tier corporation receives a dividend from that foreign corporation, the second-tier corporation owns at least 10 percent of the foreign corporation's voting stock and the product of the following equals at least 5 percent—

(i) The percentage of voting stock owned by the domestic shareholder in the first-tier corporation; multiplied by

(ii) The percentage of voting stock owned by the first-tier corporation in the second-tier corporation; multiplied by

(iii) The percentage of voting stock owned by the second-tier corporation in the third-tier corporation.

(5) *Example.* The following example illustrates the ownership requirements of paragraphs (a)(1) through (4) of this section.

*Example.* (i) Domestic corporation M owns 30 percent of the voting stock of foreign corporation A on January 1, 1991, and for all periods thereafter. Corporation A owns 40 percent of the voting stock of foreign corporation B on January 1, 1991, and continues to own that stock until June 1, 1991, when Corporation A sells its stock in Corporation B. Both Corporation A and Corporation B use the calendar year as the taxable year. Corporation B pays a dividend out of its post-1986 undistributed earnings to Corporation A, which Corporation A receives on February 16, 1991. Corporation A pays a dividend out of its post-1986 undistributed earnings to Corporation M, which Corporation M receives on January 20, 1992. Corporation M uses a fiscal year ending on June 30 as the taxable year.

(ii) On February 16, 1991, when Corporation B pays a dividend to Corporation A, Corporation M satisfies the 10- percent stock ownership requirement of paragraphs (a)(1) and (a)(2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder of Corporation A within the meaning of paragraph (a)(1) of this section. Also on February 16, 1991, Corporation B is a second-tier corporation within the meaning of paragraph (a)(3) of this section because Corporation A owns at least 10 percent of its voting stock, and the percentage of voting stock owned by Corporation M in Corporation A on February 16, 1991 (30 percent) multiplied by the percentage of voting stock owned by Corporation A in Corporation B on February 16, 1991 (40 percent) equals 12 percent. Corporation A shall be deemed to have paid foreign income taxes of Corporation B with respect to the dividend received from Corporation B on February 16, 1991.

(iii) On January 20, 1992, Corporation M satisfies the 10-percent stock ownership requirement of paragraphs (a)(1) and (2) of this section with respect to Corporation A. Therefore, Corporation A is a first-tier corporation within the meaning of paragraph (a)(2) of this section and Corporation M is a domestic shareholder within the meaning of paragraph (a)(1) of this section. Accordingly, for its taxable year ending on June 30, 1992, Corporation M is deemed to have paid a portion of the post-1986 foreign income taxes paid, accrued, or deemed to be paid, by Corporation A. Those taxes will include taxes paid by Corporation B that were deemed paid by Corporation A with respect to the dividend paid by Corporation B to Corporation A on February 16, 1991, even though Corporation B is no longer a second-tier corporation with respect to Corporations A and M on January 20, 1992, and has not been a second-tier corporation with respect to Corporations A and M at any time during the taxable years of Corporations A and M that include January 20, 1992.

(6) *Upper- and lower-tier corporations.* In the case of a third-tier corporation, the term upper-tier corporation means a first- or second-tier corporation. In the case of a second-tier corporation, the term upper-tier corporation means a first-tier corporation. In the case of a first-tier corporation, the term lower-tier corporation means a second- or third-tier corporation. In the case of a second-tier corporation, the term lower-tier corporation means a third- tier corporation.

(7) *Foreign income taxes.* The term foreign income taxes means income, war profits, and excess profits taxes as defined in § 1.901–2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903, that are imposed by a foreign country or a possession of the United States, including any such taxes deemed paid by a foreign corporation under this section. Foreign income, war profits, and excess profits taxes shall not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See also paragraphs (c) (4) and (5) of this section (concerning foreign taxes paid with respect to foreign mineral income and in connection with the purchase or sale of oil and gas).

(8) *Post-1986 foreign income taxes*—(i) *In general.* Except as provided in paragraphs (a)(10) and (13) of this section, the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued, or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend, and the foreign income taxes paid, accrued, or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign taxes were not paid or deemed paid by the foreign corporation on or with respect to earnings that in prior taxable years were distributed to or otherwise included in the income of a foreign or domestic shareholder, for example under sections 304, 367(b), 551, 951(a), 1248, or 1293 (whether or not the shareholder is deemed to have paid the foreign taxes). Thus, if a dividend is paid by a foreign corporation to a United States person that is not a domestic shareholder, or to a foreign person that is not a first- or second-tier corporation, then although no foreign income taxes shall be deemed paid under section 902 with respect to that dividend, foreign income taxes that would have been deemed paid had section 902 applied shall be removed from post-1986 foreign income taxes. In the case of a foreign corporation the foreign income taxes of which are determined based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Post-1986 foreign income taxes shall include foreign income taxes that are deemed paid by an upper-tier corporation with respect to distributions from a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, provided the upper-tier corporation's earnings and profits in that year are included in its post-1986 undistributed earnings under paragraph (a)(9) of the section. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the lower-tier corporation into dollars at the spot exchange rate in effect on the date of the distribution. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Foreign income taxes paid or accrued with respect to high withholding tax interest.* Post-1986 foreign income taxes shall not include foreign income taxes paid or accrued by a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)(i)) with respect to high withholding tax interest (as defined in section 904(d)(2)(B)) to the extent the foreign tax rate imposed on such interest exceeds 5 percent. See section 904(d)(2)(E)(ii) and § 1.904–4(g)(2)(iii). The reduction in foreign income taxes paid or accrued by the amount of tax in excess of 5 percent imposed on high withholding tax interest income must be computed in functional currency before foreign income taxes are translated into U.S. dollars and included in post-1986 foreign income taxes.

(9) *Post-1986 undistributed earnings*—(i) *In general.* Except as provided in paragraphs (a) (10) and (13) of this section, the term post-1986 undistributed earnings means the amount of the earnings and profits of a foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years of the foreign corporation beginning after December 31, 1986, determined as of the close of the taxable year of the foreign corporation in which it distributes a dividend. Post-1986 undistributed earnings shall not be reduced by reason of any earnings distributed or otherwise included in income, for example, under section 304, 367(b), 551, 951(a), 1248, or 1293, during the taxable year. Post-1986 undistributed earnings shall be reduced by the amount of earnings distributed or amounts otherwise included in income in prior taxable years beginning after December 31, 1986 (whether or not the shareholder is deemed to have paid any foreign taxes). For rules on carrybacks and carryforwards of deficits and their effect on post-1986 undistributed earnings, see § 1.902–2. In the case of a foreign corporation the foreign income taxes of which are computed based on an accounting period of less than one year, the term year means that accounting period. See sections 441(b)(3) and 443.

(ii) *Distributions out of earnings and profits accumulated by a lower-tier corporation in its taxable years beginning before January 1, 1987, and included in the gross income of an upper-tier corporation in its taxable year beginning after December 31, 1986.* Distributions by a lower-tier corporation out of non-previously taxed pre-1987 accumulated profits, as defined in paragraph (a)(10) of this section, that are received by an upper-tier corporation in any taxable year of the upper-tier corporation beginning after December 31, 1986, shall be treated as post-1986 undistributed earnings of the upper-tier corporation, provided the upper-tier corporation's earnings and profits for that year are included in its post-1986 undistributed earnings under paragraph (a)(9)(i) of this section. To determine the character of the earnings and profits and associated taxes for foreign tax credit limitation purposes, see section 904 and § 1.904–7(a).

(iii) *Reduction for foreign income taxes paid or accrued.* In computing post-1986 undistributed earnings, earnings and profits shall be reduced by foreign income taxes paid or accrued regardless of whether the taxes are creditable. Thus, earnings and profits shall be reduced by foreign income taxes paid with respect to high withholding tax interest even though a portion of the taxes is not creditable pursuant to section 904(d)(2)(E)(ii) and is not included in post-1986 foreign income taxes under paragraph (a)(7)(iii) of this section. Earnings and profits of an upper-tier corporation, however, shall not be reduced by foreign income taxes paid by a lower-tier corporation and deemed to have been paid by the upper-tier corporation.

(iv) *Special allocations.* Post-1986 undistributed earnings is the total amount of the earnings of the corporation determined at the corporate level. Special allocations of earnings and taxes to particular shareholders, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. If, however, there is an agreement to pay dividends only out of earnings in the separate categories for passive or high withholding tax interest income, then only taxes imposed on passive or high withholding tax interest earnings shall be treated as related to the dividend. See § 1.904–6(a)(2).

(10) *Pre-1987 accumulated profits*—(i) *Definition.* The term pre-1987 accumulated profits means the amount of the earnings and profits of a foreign corporation computed in accordance with section 902 and attributable to its taxable years beginning before January 1, 1987. If the special effective date of paragraph (a)(13) of this section applies, pre-1987 accumulated profits also includes any earnings and profits (computed in accordance with sections 964(a) and 986) attributable to the foreign corporation's taxable years beginning after December 31, 1986, but before the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a) (1) through (4) of this section are met with respect to that corporation.

(ii) *Computation of pre-1987 accumulated profits.* Pre-1987 accumulated profits must be computed under United States principles governing the computation of earnings and profits. Pre-1987 accumulated profits are determined at the corporate level. Special allocations of accumulated profits and taxes to particular shareholders with respect to distributions of pre-1987 accumulated profits in taxable years beginning after December 31, 1986, whether required or permitted by foreign law or a shareholder agreement, shall be disregarded. Pre-1987 accumulated profits of a particular year shall be reduced by amounts distributed from those accumulated profits or otherwise included in income from those accumulated profits, for example, under sections 304, 367(b), 551, 951(a), 1248, or 1293. If a deficit in post-1986 undistributed earnings is carried back to offset pre-1987 accumulated profits, pre-1987 accumulated profits of a particular taxable year shall be reduced by the amount of the deficit carried back to that year. See § 1.902–2. The amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under section 902, shall be determined and translated into United States dollars by applying the law as in effect prior to the effective date of the Tax Reform Act of 1986. See §§ 1.902–3, 1.902–4, and 1.964–1.

(iii) *Foreign income taxes attributable to pre-1987 accumulated profits.* The term pre-1987 foreign income taxes means any foreign income taxes paid, accrued or deemed paid on or with respect to pre-1987 accumulated profits. Pre-1987 foreign income taxes of a particular year shall be reduced by the amount of taxes paid or deemed paid on or with respect to a distribution or inclusion out of pre-1987 accumulated profits of that year, and by the amount of taxes that would have been deemed paid had section 902 applied to a distribution or inclusion with respect to a person not eligible for a section 902 credit. Foreign income taxes deemed paid with respect to a distribution of pre-1987 accumulated profits shall be translated from the functional currency of the distributing corporation into United States dollars at the spot exchange rate in effect on the date of the distribution.

(11) *Dividend.* For purposes of section 902, the definition of the term dividend in section 316 and the regulations under that section applies. The term dividend also includes deemed dividends under sections 304, 367(b), 551, and 1248, but not deemed inclusions under sections 951(a) and 1293.

(12) *Dividend received.* A dividend shall be considered received for purposes of section 902 when the cash or other property is unqualifiedly made subject to the demands of the distributee. See § 1.301–1(b). A dividend also is considered received for purposes of section 902 when it is deemed received under section 304, 367(b), 551, or 1248.

(13) *Special effective date*—(i) *Rule.* If the first day on which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met with respect to a foreign corporation, without regard to whether a dividend is distributed, is in a taxable year of the foreign corporation beginning after December 31, 1986, then—

(A) The post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation shall be determined by taking into account only taxable years beginning on and after the first day of the first taxable year of the foreign corporation in which the ownership requirements are met, including subsequent taxable years in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met; and

(B) Earnings and profits accumulated prior to the first day of the first taxable year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are met shall be considered pre-1987 accumulated profits.

(ii) *Example.* The following example illustrates the special effective date rules of this paragraph (a)(13):

*Example.* As of December 31, 1991, and since its incorporation, foreign corporation A has owned 100 percent of the stock of foreign corporation B. Corporation B is not a controlled foreign corporation. Corporation B uses the calendar year as its taxable year, and its functional currency is the u. Assume 1u equals $1 at all relevant times. On April 1, 1992, Corporation B pays a 200u dividend to Corporation A and the ownership requirements of section 902(c)(3)(B) and paragraphs (a)(1) through (4) of this section are not met at that time. On July 1, 1992, domestic corporation M purchases 10 percent of the Corporation B stock from Corporation A and, for the first time, Corporation B meets the ownership requirements of section 902(c)(3)(B) and paragraph (a)(2) of this section. Corporation M uses the calendar year as its taxable year. Corporation B does not distribute any dividends to Corporation M during 1992. For its taxable year ending December 31, 1992, Corporation B has 500u of earnings and profits (after foreign taxes but before taking into account the 200u distribution to Corporation A) and pays 100u of foreign income taxes that is equal to $100. Pursuant to paragraph (a)(13)(i) of this section, Corporation B's post-1986 undistributed earnings and post-1986 foreign income taxes will include earnings and profits and foreign income taxes attributable to Corporation B's entire 1992 taxable year and all taxable years thereafter. Thus, the April 1, 1992, dividend to Corporation A will reduce post-1986 undistributed earnings to 300u (500u–200u) under paragraph (a)(9)(i) of this section. The foreign income taxes attributable to the amount distributed as a dividend to Corporation A will not be creditable because Corporation A is not a domestic shareholder. Post-1986 foreign income taxes, however, will be reduced by the amount of foreign taxes attributable to the dividend. Thus, as of the beginning of 1993, Corporation B has $60 ($100 − [$100 x 40% (200u/500u)]) of post-1986 foreign income taxes. See paragraphs (a)(8)(i) and (b)(1) of this section.

(b) *Computation of foreign income taxes deemed paid by a domestic shareholder, first-tier corporation, and second-tier corporation*—(1) *General rule.* If a foreign corporation pays a dividend in any taxable year out of post-1986 undistributed earnings to a shareholder that is a domestic shareholder or an upper-tier corporation at the time it receives the dividend, the recipient shall be deemed to have paid the same proportion of any post-1986 foreign income taxes paid, accrued or deemed paid by the distributing corporation on or with respect to post-1986 undistributed earnings which the amount of the dividend out of post-1986 undistributed earnings (determined without regard to the gross-up under section 78) bears to the amount of the distributing corporation's post-1986 undistributed earnings. An upper-tier corporation shall not be entitled to compute an amount of foreign taxes deemed paid on a dividend from a lower-tier corporation, however, unless the ownership requirements of paragraphs (a)(1) through (4) of this section are met at each tier at the time the upper-tier corporation receives the dividend. Foreign income taxes deemed paid by a domestic shareholder or an upper-tier corporation must be computed under the following formula:

(2) *Allocation rule for dividends attributable to post-1986 undistributed earnings and pre-1987 accumulated profits*—(i) *Portion of dividend out of post-1986 undistributed earnings.* Dividends will be deemed to be paid first out of post-1986 undistributed earnings to the extent thereof. If dividends exceed post-1986 undistributed earnings and dividends are paid to more than one shareholder, then the dividend to each shareholder shall be deemed to be paid pro rata out of post-1986 undistributed earnings, computed as follows:

$$\frac{\text{Foreign income taxes deemed paid by domestic shareholder (or upper-tier corporation)} = \text{Post-1986 foreign income taxes of first-tier corporation (or lower-tier corporation)} \times \text{Dividend paid to domestic shareholder (or upper-tier corporation) by first-tier corporation (or lower-tier corporation)}}{\text{Post-1986 undistributed earnings of first-tier corporation (or lower-tier corporation)}}$$

(ii) *Portion of dividend out of pre-1987 accumulated profits.* After the portion of the dividend attributable to post-1986 undistributed earnings is determined under paragraph (b)(2)(i) of this section, the remainder of the dividend received by a shareholder is attributable to pre-1987 accumulated profits to the extent thereof. That part of the dividend attributable to pre-1987 accumulated profits will be treated as paid first from the most recently accumulated earnings and profits. See § 1.902–3. If dividends paid out of pre-1987 accumulated profits are attributable to more than one pre-1987 taxable year and are paid to more than one shareholder, then the dividend to each shareholder attributable to earnings and profits accumulated in a particular pre-1987 taxable year shall be deemed to be paid pro rata out of accumulated profits of that taxable year, computed as follows:

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Post-1986 Undistributed Earnings} = \text{Post-1986 Undistributed Earnings} \times \text{Dividend to Shareholder}}{\text{Total Dividends Paid To all Shareholders}}$$

$$\frac{\text{Portion of Dividend to a Shareholder Attributable to Accumulated Profits of a Particular Pre-1987 Taxable Year} = \text{Dividend Paid Out of Pre-1987 Accumulated Profits with Respect to the Particular Pre-1987 Taxable Year} \times \text{Dividend to Shareholder}}{\text{Total Dividends Paid to all Shareholders}}$$

(3) *Dividends paid out of pre-1987 accumulated profits.* If dividends are paid by a first-tier corporation or a lower-tier corporation out of pre-1987 accumulated profits, the domestic shareholder or upper-tier corporation that receives the dividends shall be deemed to have paid foreign income taxes to the extent provided under section 902 and the regulations thereunder as in effect prior to the effective date of the Tax Reform Act of 1986. See paragraphs (a)(10) and (13) of this section and §§ 1.902–3 and 1.902–4.

(4) *Deficits in accumulated earnings and profits.* No foreign income taxes shall be deemed paid with respect to a distribution from a foreign corporation out of current earnings and profits that is treated as a dividend under section 316(a)(2) if, as of the end of the taxable year in which the dividend is paid or accrued, the corporation has zero or a deficit in post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits is zero or less than zero. The dividend shall reduce post-1986 undistributed earnings and accumulated earnings and profits.

(5) *Examples.* The following examples illustrate the rules of this paragraph (b).

*Example 1.* Domestic corporation M owns 100 percent of foreign corporation A. Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. All of Corporation A's pre-1987 accumulated profits and post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). As of December 31, 1992, Corporation A has 100u of post-1986 undistributed earnings and $40 of post-1986 foreign income taxes. For its 1986 taxable year, Corporation A has accumulated profits of 200u (net of foreign taxes) and paid 60u of foreign income taxes on those earnings. In 1992, Corporation A distributes 150u to Corporation M. Corporation A has 100u of post-1986 undistributed earnings and the dividend, therefore, is treated as paid out of post-1986 undistributed earnings to the extent of 100u. The first 100u distribution is from post-1986 undistributed earnings, and, because the distribution exhausts those earnings, Corporation M is deemed to have paid the entire amount of post-1986 foreign income taxes of Corporation A ($40). The remaining 50u dividend is treated as a dividend out of 1986 accumulated profits under paragraph (b)(2) of this section. Corporation M is deemed to have paid $15 (60u×50u/200u, translated at the appropriate exchange rates) of Corporation A's foreign income taxes for 1986. As of January 1, 1993, Corporation A's post-1986 undistributed earnings and post-1986 foreign income taxes are 0. Corporation A has 150u of accumulated profits and 45u of foreign income taxes remaining in 1986.

*Example 2.* Domestic corporation M (incorporated on January 1, 1987) owns 100 percent of foreign corporation A (incorporated on January 1, 1987). Both Corporation M and Corporation A use the calendar year as the taxable year, and Corporation A uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. Corporation A has no pre-1987 accumulated profits. All of Corporation A's post-1986 undistributed earnings are non-subpart F general limitation earnings and profits under section 904(d)(1)(I). On January 1, 1992, Corporation A has a deficit in accumulated earnings and profits and a deficit in post-1986 undistributed earnings of (200u). No foreign taxes have been paid with respect to post-1986 undistributed earnings. During 1992, Corporation A earns 100u (net of foreign taxes), pays $40 of foreign taxes on those earnings and distributes 50u to Corporation M. As of the end of 1992, Corporation A has a deficit of (100u) ((200u) post-1986 undistributed earnings + 100u current earnings and profits) in post-1986 undistributed earnings. Corporation A, however, has current earnings and profits of 100u. Therefore, the 50u distribution is treated as a dividend in its entirety under section 316(a)(2). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign taxes paid by Corporation A because post-1986 undistributed earnings and the sum of current plus accumulated earnings and profits are (100u). The dividend reduces both post-1986 undistributed earnings and accumulated earnings and profits. Therefore, as of January 1, 1993, Corporation A's post-1986 undistributed earnings are (150u) and its accumulated earnings and profits are (150u). Corporation A's post-1986 foreign income taxes at the start of 1993 are $40.

(c) *Special rules*—(1) *Separate computations required for dividends from each first-tier and lower-tier corporation*—(i) *Rule.* If in a taxable year dividends are received by a domestic shareholder or an upper-tier corporation from two or more first-tier corporations or two or more lower-tier corporations, the foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 (a) and (b) and paragraph (b) of this section shall be computed separately with respect to the dividends received from each first-tier corporation or lower-tier corporation. If a domestic shareholder receives dividend distributions from one or more first-tier corporations and in the same taxable year the first-tier corporation receives dividends from one or more lower-tier corporations, then the amount of foreign income taxes deemed paid shall be computed by starting with the lowest-tier corporation and working upward.

(ii) *Example.* The following example illustrates the application of this paragraph (c)(1):

*Example.* P, a domestic corporation, owns 40 percent of the voting stock of foreign corporation S. S owns 30 percent of the voting stock of foreign corporation T, and 30 percent of the voting stock of foreign corporation U. Neither S, T, nor U is a controlled foreign corporation. P, S, T and U all use the calendar year as their taxable year. In 1993, T and U both pay dividends to S and S pays a dividend to P. To compute foreign taxes deemed paid, paragraph (c)(1) of this section requires P to start with the lowest tier corporations and to compute foreign taxes deemed paid separately for dividends from each first-tier and lower-tier corporation. Thus, S first will compute foreign taxes deemed paid separately on its dividends from T and U. The deemed paid taxes will be added to S's post-1986 foreign income taxes, and the dividends will be added to S's post-1986 undistributed earnings. Next, P will compute foreign taxes deemed paid with respect to the dividend from S. This computation will take into account the taxes paid by T and U and deemed paid by S.

(2) *Section 78 gross-up*—(i) *Foreign income taxes deemed paid by a domestic shareholder.* Except as provided in section 960(b) and the regulations under that section (relating to amounts excluded from gross income under section 959(b)), any foreign income taxes deemed paid by a domestic shareholder in any taxable year under section 902(a) and paragraph (b) of this section shall be included in the gross income of the domestic shareholder for the year as a dividend under section 78. Amounts included in gross income under section 78 shall, for purposes of section 904, be deemed to be derived from sources within the United States to the extent the earnings and profits on which the taxes were paid are treated under section 904(g) as United States source earnings and profits. Section 1.904–5(m)(6). Amounts included in gross income under section 78 shall be treated for purposes of section 904 as income in a separate category to the extent that the foreign income taxes were allocated and apportioned to income in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3).

(ii) *Foreign income taxes deemed paid by an upper-tier corporation.* Foreign income taxes deemed paid by an upper-tier corporation on a distribution from a lower-tier corporation are not included in the earnings and profits of the upper-tier corporation. For purposes of section 904, foreign income taxes shall be allocated and apportioned to income in a separate category to the extent those taxes were allocated to the earnings and profits of the lower-tier corporation in that separate category. See section 904(d)(3)(G) and § 1.904–6(b)(3). To the extent that section 904(g) treats the earnings of the lower-tier corporation on which those foreign income taxes were paid as United States source earnings and profits, the foreign income taxes deemed paid by the upper-tier corporation on the distribution from the lower-tier corporation shall be treated as attributable to United States source earnings and profits. See section 904(g) and § 1.904–5(m)(6).

(iii) *Example.* The following example illustrates the rules of this paragraph (c)(2):

*Example.* P, a domestic corporation, owns 100 percent of the voting stock of controlled foreign corporation S. Corporations P and S use the calendar year as their taxable year, and S uses the u as its functional currency. Assume that 1u equals $1 at all relevant times. As of January 1, 1992, S has -0- post-1986 undistributed earnings and -0- post-1986 foreign income taxes. In 1992, S earns 150u of non-subpart F general limitation income net of foreign taxes and pays 60u of foreign income taxes. As of the end of 1992, but before dividend payments, S has 150u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Assume that 50u of S's earnings for 1992 are from United States sources. S pays P a dividend of 75u which P receives in 1992. Under § 1.904–5(m)(4), one-third of the dividend, or 25u (75u×50u/150u), is United States source income to P. P computes foreign taxes deemed paid on the dividend under paragraph (b)(1) of this section of $30 ($60×50%[75u/150u]) and includes that amount in gross income under section 78 as a dividend. Because 25u of the 75u dividend is United States source income to P, $10 ($30×33.33%[25u/75u]) of the section 78 dividend will be treated as United States source income to P under this paragraph (c)(2).

(3) *Creditable foreign income taxes.* The amount of creditable foreign income taxes under section 901 shall include, subject to the limitations and conditions of sections 902 and 904,

foreign income taxes actually paid and deemed paid by a domestic shareholder that receives a dividend from a first-tier corporation. Foreign income taxes deemed paid by a domestic shareholder under paragraph (b) of this section shall be deemed paid by the domestic shareholder only for purposes of computing the foreign tax credit allowed under section 901.

(4) *Foreign mineral income.* Certain foreign income, war profits and excess profits taxes paid or accrued with respect to foreign mineral income will not be considered foreign income taxes for purposes of section 902. See section 901(e) and § 1.901–3.

(5) *Foreign taxes paid or accrued in connection with the purchase or sale of certain oil and gas.* Certain income, war profits, or excess profits taxes paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country will not be considered foreign income taxes for purposes of section 902. See section 901(f).

(6) *Foreign oil and gas extraction income.* For rules relating to reduction of the amount of foreign income taxes deemed paid with respect to foreign oil and gas extraction income, see section 907(a) and the regulations under that section.

(7) *United States shareholders of controlled foreign corporations.* See paragraph (d) of this section and sections 960 and 962 and the regulations under those sections for special rules relating to the application of section 902 in computing foreign income taxes deemed paid by United States shareholders of controlled foreign corporations.

(8) *Credit for foreign taxes deemed paid in a section 304 transaction.* [Reserved].

(9) *Effect of section 482 adjustments on post-1986 foreign income taxes and post-1986 undistributed earnings.* For rules concerning the effect of a section 482 adjustment on post-1986 foreign income taxes and post-1986 undistributed earnings, see section 905(c) and the regulations under that section.

(d) *Dividends from controlled foreign corporations*—(1) *General rule.* Except as provided in paragraph (d)(3) of this section, if a dividend is received by a domestic shareholder that is a United States shareholder (as defined in section 951(b) or section 953(c)(1)(A)) from a first-tier corporation that is a controlled foreign corporation (as defined in section 957(a) or section 953(c)(1)(B)), or by an upper-tier corporation from a lower-tier corporation if the corporations are related look-through entities within the meaning of § 1.904–5(i), the following rule applies. If a dividend is paid out of post-1986 undistributed earnings or pre-1987 accumulated profits of the upper- or lower-tier controlled foreign corporation attributable to more than one separate category under section 904(d), the amount of foreign income taxes deemed paid by the domestic shareholder or the upper-tier corporation under section 902 and paragraph (b) of this section shall be computed separately with respect to the post-1986 undistributed earnings or pre-1987 accumulated profits in each separate category out of which the dividend is paid. See § 1.904–5(c)(4) and paragraph (d)(2) of this section. The separately computed deemed paid taxes shall be added to other taxes paid by the U.S. shareholder or upper-tier corporation with respect to income in the appropriate separate category.

(2) *Look-through*—(i) *Dividends.* Except as otherwise provided in paragraph (d)(3) of this section, any dividend distribution out of post-1986 undistributed earnings of a look-through entity to a related look-through entity shall be deemed to be paid pro rata out of each separate category of income. See § 1.904–5(c)(4) and § 1.904–7. The portion of the foreign income taxes attributable to a particular separate category that shall be deemed paid by the domestic shareholder or upper-tier corporation must be computed under the following formula:

Foreign taxes deemed paid by domestic shareholder or upper-tier corporation with respect to a separate category under section 904(d) = Post-1986 foreign income taxes of first-tier or lower-tier corporation allocated and apportioned to a separate category under § 1.904–6× Dividend amount attributable to a separate category Post-1986 undistributed earnings of first-tier or lower-tier corporation attributable to the separate category

(ii) *Coordination with section 960.* For purposes of coordinating the computation of foreign taxes deemed paid with respect to amounts included in gross income pursuant to section 951(a) and dividends distributed by a controlled foreign corporation, see section 960 and the regulations under that section.

(3) *Special rules*—(i) *Dividends distributed out of earnings accumulated before a controlled foreign corporation became a controlled foreign corporation.* Any dividend distributed by a controlled foreign corporation out of earnings accumulated before the controlled foreign corporation became a controlled foreign corporation shall be treated as a dividend from a noncontrolled section 902 corporation regardless of whether the earnings were accumulated in a taxable year beginning before January 1, 1987, or after December 31, 1986.

(ii) *Dividend distributions out of earnings and profits for a year during which a shareholder that is currently a more-than-90-percent United States shareholder of a controlled foreign corporation was not a United States shareholder of the controlled foreign corporation.* A dividend shall be treated as a dividend from a noncontrolled section 902 corporation, and the look-through rules of section 904(d)(3) and § 1.904–5 shall not apply if the following conditions are met—

(A) The dividend is distributed by a controlled foreign corporation attributable to earnings and profits of a taxable year during which it was a controlled foreign corporation;

(B) The distribution is received by an upper-tier controlled foreign corporation or a United States shareholder and at the time the upper-tier controlled foreign corporation or the United States shareholder receives the distribution, the United States shareholder owns directly or indirectly within the meaning of sections 958 and 318 and the regulations under those sections, more than 90 percent of the total combined voting power of all classes of stock entitled to vote of the distributing controlled foreign corporation; and

(C) The more than 90 percent United States shareholder was not a United States shareholder at the time the distributed earnings and profits were accumulated by the controlled foreign corporation (the pre-acquisition period).

(iii) *Intra-group acquisitions.* If, however, the dividend recipient is a member of an affiliated group within the meaning of section 1504(a) without regard to section 1504(b)(3) and acquired its interest in the controlled foreign corporation from a member or members of the affiliated group, and the previous owner or owners were entitled to look-through treatment on distributions from the controlled foreign corporation, then the dividend recipient also shall be entitled to look-through treatment on distributions out of pre-acquisition period earnings and profits.

(iv) *Ordering rule.* The determination whether a distribution from a controlled foreign corporation is attributable to earnings and profits accumulated before the corporation was a controlled foreign corporation or during the pre-acquisition period shall be made on a last-in first-out (LIFO) basis. Thus, for example, a distribution shall be deemed made from the earnings and profits attributable to the period after the United States shareholder acquired more than 90 percent ownership in an existing controlled foreign corporation (post-acquisition earnings and profits) to the extent of those earnings, and then from the most recently accumulated pre-acquisition earnings and profits. Earnings and profits accumulated in the taxable year in which the corporation became a controlled foreign corporation or the United States shareholder acquired more than 90 percent ownership of the controlled foreign corporation shall be considered earnings and profits accumulated after the corporation became a controlled foreign corporation or the United States shareholder acquired more than 90 percent ownership.

(v) *Examples.* The following examples illustrate the application of this paragraph (d)(3):

*Example 1.* S is a foreign corporation formed in 1980. S had no domestic shareholders until 1992, when P, a domestic corporation, acquired 60 percent of the stock of S. For 1992 and subsequent years, S is a controlled foreign corporation. In 1992, S has no income and pays a dividend out of prior years' earnings and profits. Pursuant to paragraph (d)(3)(i) of this section, because S was not a controlled foreign corporation before 1992, the dividend to P will be treated as a dividend from a noncontrolled section 902 corporation. Further, because the 10-percent ownership requirement of paragraphs (a)(1) and (a)(2) of this section were not satisfied until 1992, the amount of foreign taxes deemed paid on any distribution out of earnings accumulated before P acquired S's stock will be computed under the rules of section 902 as in effect before the Tax Reform Act of 1986. See §§ 1.902–3 and 1.902–4 and paragraphs (a) (10) and (13) of this section.

*Example 2.* P, a domestic corporation, owns 100 percent of the stock of U, a controlled foreign corporation. In 1992, P sells 100 percent of the stock of U to T, an unrelated domestic corporation. U has no income in 1992 and pays a dividend to T out of post-1986 undistributed earnings attributable to prior years. T is not related to P and P's ownership of U will not be attributed to T. The dividend to T in 1992 thus will be treated as a dividend from a noncontrolled section 902 corporation. In 1993, U pays a dividend to T out of post-acquisition earnings and profits. T will be entitled to look-through treatment on the dividend. The amount of foreign taxes deemed paid on each distribution will be computed under the rules of this section.

*Example 3.* Since its organization in 1980, S, a controlled foreign corporation, has been owned 60 percent by domestic corporation P and 40 percent by domestic corporation R. In 1992, T acquires R's 40 percent interest in the stock of S. S has no income in 1992 and pays a dividend out of prior years' earnings and profits. Paragraph (d)(3)(ii) of this section does not apply because T, which formerly owned no stock in S, acquired only 40 percent of the stock of S. Thus, T is entitled to look-through treatment on the dividend payment out of post-1986 undistributed earnings accumulated in years prior to 1992.

(e) *Information to be furnished.* If the credit for foreign income taxes claimed under section 901 includes foreign income taxes deemed paid under section 902 and paragraph (b) of this section, the domestic shareholder must furnish the same information with respect to the foreign income taxes deemed paid as it is required to furnish with respect to the foreign income taxes it directly paid or accrued and for which the credit is claimed. See § 1.905–2. For other information required to be furnished by the domestic shareholder for the annual accounting period of certain foreign corporations ending with or within the shareholder's taxable year, and for reduction in the amount of foreign income taxes paid, accrued, or deemed paid for failure to furnish the required information, see section 6038 and the regulations under that section.

(f) *Examples.* The following examples illustrate the application of this § 1.902–1.

*Example 1.* Since 1987, domestic corporation M has owned 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation. Corporation A uses the u as its functional currency, and 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. In 1992, Corporation A pays a 30u dividend out of post-1986 undistributed earnings, 3u to Corporation M and 27u to Corporation Z. Corporation M is deemed, under paragraph (b) of this section, to have paid a portion of the post-1986 foreign income taxes paid by Corporation A and includes the amount of foreign taxes deemed paid in gross income under section 78 as a dividend. Both the foreign taxes deemed paid and the dividend would be subject to a separate limitation for dividends from Corporation A, a noncontrolled 902 corporation. Under paragraph (a)(9)(i) of this section, Corporation A must reduce its post-1986 undistributed earnings as of January 1, 1993, by the total amount of dividends paid to Corporation M and Corporation Z in 1992. Under paragraph (a)(8)(i) of this section, Corporation A must reduce its post-1986 foreign income taxes as of January 1, 1993, by the amount of foreign income taxes that were deemed paid by Corporation M and by the amount of foreign income taxes that would have been deemed paid by Corporation Z had section 902 applied to the dividend paid to Corporation Z. Foreign income taxes deemed paid by Corporation M and Corporation A's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

| | |
|---|---|
| 1. Assumed post-1986 undistributed earnings of Corporation A at start of 1992 | 25u |
| 2. Assumed post-1986 foreign income taxes of Corporation A at start of 1992 | $25 |
| 3. Assumed pre-tax earnings and profits of Corporation A for 1992 | 50u |
| 4. Assumed foreign income taxes paid or accrued by Corporation A in 1992 | 15u |
| 5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 60u |
| 6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates). | $40 |
| 7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1992 | 3u |
| 8. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M (Line 7 divided by Line 5) | 5% |
| 9. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902 (a) (Line 6 multiplied by Line 8) | $2 |
| 10. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992 | 30u |
| 11. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5) | 50% |
| 12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11). | $20 |
| 13. Corporation A's post-1986 undistributed earnings at the start of 1993 (Line 5 minus Line 10) | 30u |
| 14. Corporation A's post-1986 foreign income taxes at the start of 1993 (Line 6 minus Line 12) | $20 |

*Example 2.* (i) The facts are the same as in *Example 1,* except that Corporation M has also owned 10 percent of the one class of stock of foreign corporation B since 1987. Corporation B uses the calendar year as the taxable year. The remaining 90 percent of Corporation B's stock is owned by Corporation Z. Corporation B is not a controlled foreign corporation. Corporation B uses the u as its functional currency, and 1u equals $1 at all relevant times. In 1992, Corporation B has earnings and profits and pays foreign income taxes, a portion of which are attributable to high withholding tax interest, as defined in section 904(d)(2)(B)(i). Corporation B must reduce its pool of post-1986 foreign income taxes by the amount of tax imposed on high withholding tax interest

in excess of 5 percent because these taxes are not eligible for the deemed paid credit. See section 904(d)(2)(E)(ii) and paragraph (a)(8)(iii) of this section. Corporation B pays 50u in dividends in 1992, 5u to Corporation M and 45u to Corporation Z. Corporation M must compute its section 902(a) deemed paid credit separately for the dividends it receives in 1992 from Corporation A (as computed in *Example 1*) and from Corporation B. Foreign income taxes of Corporation B deemed paid by Corporation M, and Corporation B's opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for 1993 are computed as follows:

| | |
|---|---|
| 1. Assumed post-1986 undistributed earnings of Corporation B at start of 1992 | (100u) |
| 2. Assumed post-1986 foreign income taxes of Corporation B at start of 1992 | $0 |
| 3. Assumed pre-tax earnings and profits of Corporation B for 1992 (including 50u of high withholding tax interest on which 5u of tax is withheld). | 302.50u |
| 4. Assumed foreign income taxes paid or accrued by Corporation B in 1992 | 102.50u |
| 5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 100u |
| 6. Amount of foreign income tax of Corporation B imposed on high withholding tax interest in excess of 5% (5u withholding tax—[5%×50u high withholding tax interest]). | 2.50u |
| 7. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus [Line 4 minus Line 6 translated at the appropriate exchange rate]). | $100 |
| 8. Dividends paid out of post-1986 undistributed earnings to Corporation M in 1992 | 5u |
| 9. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation M (Line 8 divided by Line 5) | 5% |
| 10. Foreign income taxes of Corporation B deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9) | $5 |
| 11. Total dividends paid out of post-1986 undistributed earnings of Corporation B to all shareholders in 1992 | 50u |
| 12. Percentage of Corporation B's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 5) | 50% |
| 13. Post-1986 foreign income taxes of Corporation B paid on or with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12). | $50 |
| 14. Corporation B's post-1986 undistributed earnings at start of 1993 (Line 5 minus Line 11) | 50u |
| 15. Corporation B's post-1986 foreign income taxes at start of 1993 (Line 7 minus Line 13) | $50 |

(ii) For 1992, as computed in *Example 1*, Corporation M is deemed to have paid $2 of the post-1986 foreign income taxes paid by Corporation A and includes $2 in gross income as a deemed dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. Corporation M also is deemed to have paid $5 of the post-1986 foreign income taxes paid by Corporation B and includes $5 in gross income as a deemed dividend under section 78. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation B, a noncontrolled section 902 corporation.

*Example 3.* (i) Since 1987, domestic corporation M has owned 50 percent of the one class of stock of foreign corporation A. The remaining 50 percent of Corporation A is owned by foreign corporation Z. For the same time period, Corporation A has owned 40 percent of the one class of stock of foreign corporation B, and Corporation B has owned 30 percent of the one class of stock of foreign corporation C. The remaining 60 percent of Corporation B is owned by foreign corporation Y, and the remaining 70 percent of Corporation C is owned by foreign corporation X. Corporations A, B, and C are not controlled foreign corporations. Corporations A, B, and C use the u as their functional currency, and 1u equals $1 at all relevant times. Corporation B uses a fiscal year ending June 30 as its taxable year; all other corporations use the calendar year as the taxable year. On February 1, 1992, Corporation C pays a 500u dividend out of post-1986 undistributed earnings, 150u to Corporation B and 350u to Corporation X. On February 15, 1992, Corporation B pays a 300u dividend out of post-1986 undistributed earnings computed as of the close of Corporation B's fiscal year ended June 30, 1992, 120u to Corporation A and 180u to Corporation Y. On August 15, 1992, Corporation A pays a 200u dividend out of post-1986 undistributed earnings, 100u to Corporation M and 100u to Corporation Z. In computing foreign taxes deemed paid by Corporations B and A, section 78 does not apply and Corporations B and A thus do not have to include the foreign taxes deemed paid in earnings and profits. See paragraph (c)(2)(ii) of this section. Foreign income taxes deemed paid by Corporations B, A and M, and the foreign corporations' opening balances in post-1986 undistributed earnings and post-1986 foreign income taxes for Corporation B's fiscal year beginning July 1, 1992, and Corporation C's and Corporation A's 1993 calendar years are computed as follows:

| | |
|---|---|
| A. Corporation C (third-tier corporation): | |
| 1. Assumed post-1986 undistributed earnings in Corporation C at start of 1992 | 1300u |
| 2. Assumed post-1986 foreign income taxes in Corporation C at start of 1992 | $500 |
| 3. Assumed pre-tax earnings and profits of Corporation C for 1992 | 500u |
| 4. Assumed foreign income taxes paid or accrued in 1992 | 300u |
| 5. Post-1986 undistributed earnings in Corporation C for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 1500u |
| 6. Post-1986 foreign income taxes in Corporation C for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates). | $800 |
| 7. Dividends paid out of post-1986 undistributed earnings of Corporation C to Corporation B in 1992 | 150u |
| 8. Percentage of Corporation C's post-1986 undistributed earnings paid to Corporation B (Line 7 divided by Line 5) | 10% |
| 9. Foreign income taxes of Corporation C deemed paid by Corporation B under section 902(b)(2) (Line 6 multiplied by Line 8). | $80 |
| 10. Total dividends paid out of post-1986 undistributed earnings of Corporation C to all shareholders in 1992 | 500u |
| 11. Percentage of Corporation C's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 10 divided by Line 5). | 33.33% |
| 12. Post-1986 foreign income taxes paid with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 6 multiplied by Line 11). | $266.66 |
| 13. Post-1986 undistributed earnings in Corporation C at start of 1993 (Line 5 minus Line 10) | 1000u |
| 14. Post-1986 foreign income taxes in Corporation C at start of 1993 (Line 6 minus Line 12) | $533.34 |
| B. Corporation B (second-tier corporation): | |
| 1. Assumed post-1986 undistributed earnings in Corporation B as of July 1, 1991 | 0 |
| 2. Assumed post-1986 foreign income taxes in Corporation B as of July 1, 1991 | 0 |
| 3. Assumed pre-tax earnings and profits of Corporation B for fiscal year ended June 30, 1992, (including 150u dividend from Corporation B). | 1000u |
| 4. Assumed foreign income taxes paid or accrued by Corporation B in fiscal year ended June 30, 1992 | 200u |

| | |
|---|---|
| 5. Foreign income taxes of Corporation C deemed paid by Corporation B in its fiscal year ended June 30, 1992 (Part A, Line 9 of paragraph (i) of this Example 3). | $80 |
| 6. Post-1986 undistributed earnings in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4). | 800u |
| 7. Post-1986 foreign income taxes in Corporation B for fiscal year ended June 30, 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5). | $280 |
| 8. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A on February 15, 1992 | 120u |
| 9. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to Corporation A (Line 8 divided by Line 6). | 15% |
| 10. Foreign income taxes paid and deemed paid by Corporation B as of June 30, 1992, deemed paid by Corporation A under section 902(b)(1) (Line 7 multiplied by Line 9). | $42 |
| 11. Total dividends paid out of post-1986 undistributed earnings of Corporation B for fiscal year ended June 30, 1992 | 300u |
| 12. Percentage of Corporation B's post-1986 undistributed earnings for fiscal year ended June 30, 1992, paid to all shareholders (Line 11 divided by Line 6). | 37.5% |
| 13. Post-1986 foreign income taxes paid and deemed paid with respect to post-1986 undistributed earnings distributed to all shareholders during Corporation B's fiscal year ended June 30, 1992 (Line 7 multiplied by Line 12). | $105 |
| 14. Post-1986 undistributed earnings in Corporation B as of July 1, 1992 (Line 6 minus Line 11) | 500u |
| 15. Post-1986 foreign income taxes in Corporation B as of July 1, 1992 (Line 7 minus Line 13) | $175 |
| C. Corporation A (first-tier corporation): | |
| 1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 | 250u |
| 2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 | $100 |
| 3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 120u dividend from Corporation B) | 250u |
| 4. Assumed foreign income taxes paid or accrued by Corporation A in 1992 | 100u |
| 5. Foreign income taxes paid or deemed paid by Corporation B as of June 30, 1992, that are deemed paid by Corporation A in 1992 (Part B, Line 10 of paragraph (i) of this *Example 3).* | $42 |
| 6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 400u |
| 7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5). | $242 |
| 8. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M on August 15, 1992 | 100u |
| 9. Percentage of Corporation A's post-1986 undistributed earnings paid to Corporation M in 1992 (Line 8 divided by Line 6). | 25% |
| 10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9). | $60.50 |
| 11. Total dividends paid out of post-1986 undistributed earnings of Corporation A to all shareholders in 1992 | 200u |
| 12. Percentage of Corporation A's post-1986 undistributed earnings paid to all shareholders in 1992 (Line 11 divided by Line 6). | 50% |
| 13. Post-1986 foreign income taxes paid and deemed paid by Corporation A with respect to post-1986 undistributed earnings distributed to all shareholders in 1992 (Line 7 multiplied by Line 12). | $121 |
| 14. Post-1986 undistributed earnings in Corporation A at start of 1993 (Line 6 minus Line 11) | 200u |
| 15. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 13) | $121 |

(ii) Corporation M is deemed, under section 902(a) and paragraph (b) of this section, to have paid $60.50 of post-1986 foreign income taxes paid, or deemed paid, by Corporation A on or with respect to its post-1986 undistributed earnings (Part C, Line 10) and Corporation M includes that amount in gross income as a dividend under section 78. Both the income inclusion and the credit are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation.

*Example 4.* (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A, and Corporation A has owned 100 percent of the voting stock of controlled foreign corporation B. Corporations M, A and B use the calendar year as the taxable year. Corporations A and B are organized in the same foreign country and use the u as their functional currency. 1u equals $1 at all relevant times. Assume that all of the earnings of Corporations A and B are general limitation earnings and profits within the meaning of section 904(d)(2)(I), and that neither Corporation A nor Corporation B has any previously taxed income accounts. In 1992, Corporation B pays a dividend of 150u to Corporation A out of post-1986 undistributed earnings, and Corporation A computes an amount of foreign taxes deemed paid under section 902(b)(1). The dividend is not subpart F income to Corporation A because section 954(c)(3)(B)(i) (the same country dividend exception) applies. Pursuant to paragraph (c)(2)(ii) of this section, Corporation A is not required to include the deemed paid taxes in earnings and profits. Corporation A has no pre-1987 accumulated profits and a deficit in post-1986 undistributed earnings for 1992. In 1992, Corporation A pays a dividend of 100u to Corporation M out of its earnings and profits for 1992 (current earnings and profits). Under paragraph (b)(4) of this section, Corporation M is not deemed to have paid any of the foreign income taxes paid or deemed paid by Corporation A because Corporation A has a deficit in post-1986 undistributed earnings as of December 31, 1992, and the sum of its current plus accumulated profits is less than zero. Note that if instead of paying a dividend to Corporation A in 1992, Corporation B had made an additional investment of $150 in United States property under section 956, that amount would have been included in gross income by Corporation M under section 951(a)(1)(B) and Corporation M would have been deemed to have paid $50 of foreign income taxes paid by Corporation B. See sections 951(a)(1)(B) and 960.

| | |
|---|---|
| A. Corporation B (second-tier corporation): | |
| 1. Assumed post-1986 undistributed earnings in Corporation B at start of 1992 | 200u |
| 2. Assumed post-1986 foreign income taxes in Corporation B at start of 1992 | $50 |
| 3. Assumed pre-tax earnings and profits of Corporation B for 1992 | 150u |
| 4. Assumed foreign income taxes paid or accrued in 1992 | 50u |
| 5. Post-1986 undistributed earnings in Corporation B for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 300u |
| 6. Post-1986 foreign income taxes in Corporation B for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates). | $100 |
| 7. Dividends paid out of post-1986 undistributed earnings of Corporation B to Corporation A in 1992 | 150u |
| 8. Percentage of Corporation B's post-1986 undistributed earnings paid to Corporation A (Line 7 divided by Line 5) | 50% |

| | |
|---|---|
| 9. Foreign income taxes of Corporation B deemed paid by Corporation A under section 902(b)(1) (Line 6 multiplied by Line 8). | $50 |
| 10. Post-1986 undistributed earnings in Corporation B at start of 1993 (Line 5 minus Line 7) | 150u |
| 11. Post-1986 foreign income taxes in Corporation B at start of 1993 (Line 6 minus Line 9) | $50 |
| B. Corporation A (first-tier corporation): | |
| 1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 | (200u) |
| 2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 | 0 |
| 3. Assumed pre-tax earnings and profits of Corporation A for 1992 (including 150u dividend from Corporation B) | 200u |
| 4. Assumed foreign income taxes paid or accrued by Corporation A in 1992 | 40u |
| 5. Foreign income taxes paid by Corporation B in 1992 that are deemed paid by Corporation A (Part A, Line 9 of paragraph (i) of this *Example 4*). | $50 |
| 6. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | (40u) |
| 7. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates plus Line 5). | $90 |
| 8. Dividends paid out of current earnings and profits of Corporation A for 1992 | 100u |
| 9. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1992 (Line 8 divided by the greater of Line 6 or zero). | 0 |
| 10. Foreign income taxes paid and deemed paid by Corporation A in 1992 that are deemed paid by Corporation M under section 902(a) (Line 7 multiplied by Line 9). | 0 |
| 11. Post-1986 undistributed earnings in Corporation A at start of 1993 (line 6 minus line 8) | (140u) |
| 12. Post-1986 foreign income taxes in Corporation A at start of 1993 (Line 7 minus Line 10) | $90 |

(ii) For 1993, Corporation A has 500u of earnings and profits on which it pays 160u of foreign income taxes. Corporation A receives no dividends from Corporation B, and pays a 100u dividend to Corporation M. The 100u dividend to Corporation M carries with it some of the foreign income taxes paid and deemed paid by Corporation A in 1992, that were not deemed paid by Corporation M in 1992 because Corporation A had no post-1986 undistributed earnings. Thus, for 1993, Corporation M is deemed to have paid $125 of post-1986 foreign income taxes paid and deemed paid by Corporation A and includes that amount in gross income as a dividend under section 78, determined as follows:

| | |
|---|---|
| 1. Post-1986 undistributed earnings in Corporation A at start of 1993 | (140u) |
| 2. Post-1986 foreign income taxes in Corporation A at start of 1993 | $90 |
| 3. Pre-tax earnings and profits of Corporation A for 1993 | 500u |
| 4. Foreign income taxes paid or accrued by Corporation A in 1993 | 160u |
| 5. Post-1986 undistributed earnings in Corporation A for 1993 (pre-dividend) (Line 1 plus Line 3 minus Line 4) | 200u |
| 6. Post-1986 foreign income taxes in Corporation A for 1993 (pre-dividend) (Line 2 plus Line 4 translated at the appropriate exchange rates). | $250 |
| 7. Dividends paid out of post-1986 undistributed earnings of Corporation A to Corporation M in 1993 | 100u |
| 8. Percentage of post-1986 undistributed earnings of Corporation A paid to Corporation M in 1993 (Line 7 divided by Line 5). | 50% |
| 9. Foreign income taxes paid and deemed paid by Corporation A that are deemed paid by Corporation M in 1993 (Line 6 multiplied by Line 8). | $125 |
| 10. Post-1986 undistributed earnings in Corporation A at start of 1994 (Line 5 minus Line 7) | 100u |
| 11. Post-1986 foreign income taxes in Corporation A at start of 1994 (Line 6 minus Line 9) | $125 |

*Example 5.* (i) Since 1987, domestic corporation M has owned 100 percent of the voting stock of controlled foreign corporation A. Corporation M also conducts operations through a foreign branch. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A uses the u as its functional currency and 1u equals $1 at all relevant times. Corporation A has no subpart F income, as defined in section 952, and no increase in earnings invested in United States property under section 956 for 1992. Corporation A also has no previously taxed income accounts. Corporation A has general limitation income and high withholding tax interest income that, by operation of section 954(b)(4), does not constitute foreign base company income under section 954(a). Because Corporation A is a controlled foreign corporation, it is not required to reduce post-1986 foreign income taxes by foreign taxes paid or accrued with respect to high withholding tax interest in excess of 5 percent. See § 1.902–1(a)(8)(iii). Corporation A pays a 60u dividend to Corporation M in 1992. For 1992, Corporation M is deemed, under paragraph (b) of this section, to have paid $24 of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend, determined as follows:

| | |
|---|---|
| 1. Assumed post-1986 undistributed earnings in Corporation A at start of 1992 attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest | 20u |
| (b) Section 904(d)(1)(I) general limitation income | 55u |
| 2. Assumed post-1986 foreign income taxes in Corporation A at start of 1992 attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest | $5 |
| (b) Section 904(d)(1)(I) general limitation income | $20 |
| 3. Assumed pre-tax earnings and profits of Corporation A for 1992 attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest | 20u |
| (b) Section 904(d)(1)(I) general limitation income | 20u |
| 4. Assumed foreign income taxes paid or accrued in 1992 on or with respect to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest | 10u |
| (b) Section 904(d)(1)(I) general limitation income | 5u |
| 5. Post-1986 undistributed earnings in Corporation A for 1992 (pre-dividend) attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest (Line 1(a) + Line 3(a) minus Line 4(a)) | 30u |
| (b) Section 904(d)(1)(I) general limitation income (Line 1(b) + Line 3(b) minus Line 4(b)) | 70u |
| (c) Total | 100u |

| | |
|---|---|
| 6. Post-1986 foreign income taxes in Corporation A for 1992 (pre-dividend) attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest (Line 2(a) + Line 4(a) translated at the appropriate exchange rates) | $15 |
| (b) Section 904(d)(1)(I) general limitation income (Line 2(b) + Line 4(b) translated at the appropriate exchange rates) | $25 |
| 7. Dividends paid to Corporation M in 1992 | 60u |
| 8. Dividends paid to Corporation M in 1992 attributable to section 904(d) separate categories pursuant to § 1.904–5(d): | |
| (a) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(B) high withholding tax interest (Line 7 multiplied by Line 5(a) divided by Line 5(c). | 18u |
| (b) Dividends paid to Corporation M in 1992 attributable to section 904(d)(1)(I) general limitation income (Line 7 multiplied by Line 5(b) divided by Line 5(c). | 42u |
| 9. Percentage of Corporation A's post-1986 undistributed earnings for 1992 paid to Corporation M attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest (Line 8(a) divided by Line 5(a)) | 60% |
| (b) Section 904(d)(1)(I) general limitation income (Line 8(b) divided by Line 5(b) | 60% |
| 10. Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) attributable to: | |
| (a) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(B) high withholding tax interest (Line 6(a) multiplied by Line 9(a)). | $9 |
| (b) Foreign income taxes of Corporation A deemed paid by Corporation M under section 902(a) with respect to section 904(d)(1)(I) general limitation income (Line 6(b) multiplied by Line 9(b). | $15 |
| 11. Post-1986 undistributed earnings in Corporation A at start of 1993 attributable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest (Line 5(a) minus Line 8(a)) | 12u |
| (b) Section 904(d)(1)(I) general limitation income (Line 5(b) minus Line 8(b)) | 28u |
| 12. Post-1986 foreign income taxes in Corporation A at start of 1989 allocable to: | |
| (a) Section 904(d)(1)(B) high withholding tax interest (Line 6(a) minus Line 10(a)) | $6 |
| (b) Section 904(d)(1)(I) general limitation income (Line 6(b) minus Line 10(b)) | $10 |

(ii) For purposes of computing Corporation M's foreign tax credit limitation, the post-1986 foreign income taxes of Corporation A deemed paid by Corporation M with respect to income in separate categories will be added to the foreign income taxes paid or accrued by Corporation M associated with income derived from Corporation M's branch operation in the same separate categories. The dividend (and the section 78 inclusion with respect to the dividend) will be treated as income in separate categories and added to Corporation M's other income, if any, attributable to the same separate categories. See section 904(d) and § 1.904–6.

(g) *Effective date.* This section applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987.

*§ 1.902–2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first-, second-, or third-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902–1.*

(a) *Carryback of deficits in post-1986 undistributed earnings of a first-, second-, or third-tier corporation to pre-effective date taxable years*—(1) *Rule.* For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first-, second-, or third-tier corporation with positive accumulated profits computed under section 902. See § 1.902–3(c)(2). For purposes of this § 1.902–2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of § 1.902–1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective date year to the extent thereof and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples.* The following examples illustrate the rules of this paragraph (a):

*Example 1.* (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|
| Current E & P (deficits) of Corp. A | 150u | 150u | (100u) | 100u | -0- | -0- |
| Current plus accumulated E & P of Corp. A | 150u | 300u | 200u | 250u | 250u | 200u |
| Post-'86 undistributed earnings of Corp. A | | | (100u) | 100u | 100u | 50u |
| Post-'86 undistributed earnings of Corp. A reduced by current year dividend distributions (increased by deficit carryback). | | | -0- | 100u | 50u | 50u |
| Foreign income taxes of Corp. A (annual) | 120u | 120u | $10 | $50 | -0- | -0- |
| Post-'86 foreign income taxes of Corp. A | | | $10 | $60 | $60 | $30 |
| 12/31 distributions to Corp. M | -0- | -0- | 5u | -0- | 5u | -0- |
| 12/31 distributions to Corp. Z | -0- | -0- | 45u | -0- | 45u | -0- |

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and $10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u–100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u×(5u/50u)). See § 1.902–1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No earnings and profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and $60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are $3 ($60×5%[5u/100u]). Corporation M must include $3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u (100u–50u). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid had section 902 applied to the entire 50u dividend to Corporations M and Z, even though Corporation Z was not entitled to compute foreign taxes deemed paid on its share of the dividend. Section 1.902–1(a)(8). The amount of foreign income taxes that would have been deemed paid had section 902 applied to the entire 50u dividend is $30 ($60×50%[50u/100u]). Thus, post-1986 foreign income taxes as of January 1, 1990, are $30 ($60–$30).

*Example 2.* The facts are the same as in *Example 1,* except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u (120u×5u/150u). See § 1.902–1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u (150u–50u) of earnings and profits and 80u (120u reduced by 40u[120u×50u/150u] of foreign taxes that would have been deemed paid had section 902 applied to the total dividend paid to all shareholders out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

*Example 3.* (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| Current E & P (deficits) of Corp. A | 100u | (50u) | 150u | 75u | 25u | -0- |
| Current plus accumulated E & P of Corp. A | 100u | 50u | 200u | 175u | 200u | 80u |
| Post-'86 undistributed earnings of Corp. A | | (50u) | 100u | 75u | 100u | -0- |
| Post-'86 undistributed earnings of Corp. A reduced by current year dividend distributions (increased by deficit carryback). | | (50u) | -0- | 75u | -0- | -0- |
| Foreign income taxes (annual) of Corp. A | 80u | -0- | $120 | $20 | $20 | -0- |
| Post-'86 foreign income taxes of Corp. A | | -0- | $120 | $20 | $40 | -0- |
| 12/31 distributions to Corp. M | -0- | -0- | 10u | -0- | 12u | -0- |
| 12/31 distributions to Corp. Z | -0- | -0- | 90u | -0- | 108u | -0- |

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $120 in its post-1986 foreign income taxes. Corporation M is deemed, under § 1.902–1(b)(1), to have paid $12 ($120×10%[10u/100u]) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are -0- (100u − 100u). Its post-1986 foreign taxes as of January 1, 1989, also are -0-, $120 reduced by $120 of foreign income taxes paid that would have been deemed paid had section 902 applied to the entire 100u dividend distribution to Corporations M and Z ($120×100%[100u/100u]).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and $40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902–1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u (100u×12u/120u) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u (100u×108u/120u) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are $4 ($40×10%[10u/100u]), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u (80u × 2u/100u). Corporation M must include $4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are -0- (100u − 100u). 80u (100u − 20u) of earnings and profits remain with respect to 1986. Post-1986 foreign taxes as of January 1, 1991, are -0-, $40 reduced by $40 of foreign income taxes paid that would have been deemed paid had section 902 applied to the entire 100u dividend distribution out of post-1986 undistributed earnings to Corporations M and Z ($40×100%[100u/100u]). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [80u×20u/100u] of foreign income taxes that would have been deemed paid had section 902 applied to the entire 20u dividend distribution to Corporations M and Z out of 1986 accumulated profits.

(b) *Carryforward of deficits in pre-1987 accumulated profits of a first-, second-, or third-tier corporation to post-1986 undistributed earnings for purposes of section 902*—(1) *General rule*. For purposes of computing foreign income taxes deemed paid under § 1.902–1(b) with respect to dividends paid by a first-, second-, or third-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits determined under section 902 of the foreign corporation as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a)(1) through (4) are met if the special effective date of § 1.902–1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post- 1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985–6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b).

*Example 1.* (i) From 1984 through 1988, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| Current E & P (deficits) of Corp. A | 25u | (100u) | (25u) | 200u | 100u |
| Current Plus Accumulated E & P (Deficits) of Corp. A | 25u | (75u) | (100u) | 100u | 50u |
| Post-'86 Undistributed Earnings of Corp. A | | | | 100u | 50u |
| Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward). | | | | (50u) | 50u |
| Foreign Income Taxes (Annual) of Corp. A | 20u | 5u | -0- | $100 | $50 |
| Post-'86 Foreign Income Taxes of Corp. A | | | | $100 | $50 |
| 12/31 Distributions to Corp. M | -0- | -0- | -0- | 15u | -0- |
| 12/31 Distributions to Corp. Z | -0- | -0- | -0- | 135u | -0- |

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has $100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under § 1.902–1(b), are $10 ($100×10%[10u/100u]). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u–150u) and -0- post-1986 foreign income taxes, $100 reduced by $100 of foreign income taxes paid that would have been deemed paid had section 902 applied to the entire 100u dividend distribution out of post-1986 undistributed earnings to Corporations M and Z ($100×100%[100u/100u]).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4).

*Example 2.* (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals $1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

| Taxable year | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Current E & P (Deficits) of Corp. A | (100u) | 150u | (150u) | 100u | 250u |
| Current Plus Accumulated E & P (Deficits) of Corp. A | (100u) | 50u | (200u) | (100u) | 50u |
| Post-'86 Undistributed Earnings of Corp. A | | 50u | (200u) | (100u) | 50u |
| Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward). | | (50u) | (200u) | (200u) | -0- |
| Foreign Income Taxes (Annual) of Corp. A | -0- | $120 | -0- | $50 | $100 |
| Post-'86 Foreign Income Taxes of Corp. A | | $120 | -0- | $50 | $150 |
| 12/31 Distributions to Corp. M | -0- | 10u | -0- | 10u | 5u |
| 12/31 Distributions to Corp. Z | -0- | 90u | -0- | 90u | 45u |

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902–1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has $120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are $12 ($120×10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u − 100u) and -0- in its post-1986 foreign income taxes, $120 reduced by $120 of foreign taxes that would have been deemed paid had section 902 applied to the entire dividend out of post-1986 undistributed earnings ($120×100%[50u/50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, no portion of the dividend is deemed to be out of post-1986 undistributed earnings, and Corporation M is deemed to have paid no post-1986 foreign income taxes. See § 1.902–1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u) − 100u). Corporation A's post-1986 foreign income taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and $150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are $15 ($150×10%[5u/50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u − 50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, $150 reduced by $150 ($150×100%[50u/50u]) of foreign income taxes that would have been deemed paid had section 902 applied to the entire dividend of 50u.

**Par. 4.** Newly designated § 1.902–3 is amended by revising the section heading, paragraph (a) introductory text, and paragraph (l) to read as follows:

**§ 1.902–3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.**

(a) *Definitions.* For purposes of section 902 and §§ 1.902–3 through 1.902–4—

* * * * *

(l) *Effective date.* Except as provided in § 1.902–4, this section applies to any distribution received from a first-tier corporation by its domestic shareholder after December 31, 1964, and before the beginning of the foreign corporation's first taxable year beginning after December 31, 1986. If, however, the first day on which the ownership requirements of section 902(c)(3)(B) and § 1.902–1(a) (1) through (4) are met with respect to the foreign corporation is in a taxable year of the foreign corporation beginning after December 31, 1986, then this § 1.902–3 shall apply to all taxable years beginning after December 31, 1964, and before the year in which the ownership requirements are first met. See § 1.902–1(a)(13)(iii). For corresponding rules applicable to distributions received by the domestic shareholder prior to January 1, 1965, see § 1.902–5 as contained in the 26 CFR part 1 edition revised as of April 1, 1976.

**Margaret Milner Richardson,**

*Commissioner of Internal Revenue*

[FR Doc. 95–173 Filed 1–5–95; 8:45 am]

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## ENVIRONMENTAL PROTECTION AGENCY

### 40 CFR Part 52

**[Region II Docket No. 138, NY20–1–6729b; FRL–5124–6]**

### Approval and Promulgation of Implementation Plans; State of New York; Clean Fuel Fleet Opt Out

**AGENCY:** Environmental Protection Agency (EPA).

**ACTION:** Proposed rule.

**SUMMARY:** The EPA proposes to approve the State Implementation Plan (SIP) revision submitted by the State of New York related to the requirement that the State submit either the Clean Fuel Fleet program (CFFP) or a substitute program that meets the requirements of the Clean Air Act. The State has submitted such a substitute measure for a portion of the required program. In the final rules section of this **Federal Register**, EPA is partially approving and partially disapproving the State's SIP revision as a direct final rule without prior proposal because the Agency views this as a noncontroversial revision and anticipates no adverse comments. A detailed rationale for the action is set forth in the direct final rule. If no adverse comments are received in response to that direct final rule no further activity is contemplated in relation to this proposed rule. If EPA receives adverse comments, the direct final rule will be withdrawn and all public comments received will be addressed in a subsequent final rule based on this proposed rule. The EPA will not institute a second comment period on this proposed rule. Any parties interested in commenting on this action should do so at this time.

**DATES:** Comments must be received on or before February 6, 1995.

**ADDRESSES:** All comments should be addressed to:

William S. Baker, Chief, Air Programs Branch, Air and Waste Management Division, Environmental Protection Agency, Region II Office, 26 Federal Plaza, New York, New York 10278.

Copies of the State submittal are available at the following address for inspection during normal business hours:

Environmental Protection Agency, Region II Office, Library, 26 Federal Plaza, room 402, New York, New York 10278.

New York Department of Environmental Conservation, Division of Air Resources, 50 Wolf Road, Albany, New York 12233.

**FOR FURTHER INFORMATION CONTACT:** Michael P. Moltzen, Environmental Engineer, Technical Evaluation Section, Air Programs Branch, Environmental Protection Agency, 26 Federal Plaza, Room 1034A, New York, New York 10278, (212) 264–2517.

**SUPPLEMENTARY INFORMATION:** For additional information see the direct final rule which is published in the rules section of this **Federal Register**.

Dated: November 21, 1994.

**William J. Muszynski, P.E.**

*Acting Regional Administrator.*

[FR Doc. 95–289 Filed 1–5–95; 8:45 am]

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